

HOW TO INVEST IN EQUITIES AND STAY SANE

by Edward Hocknell

BAILLIE GIFFORD

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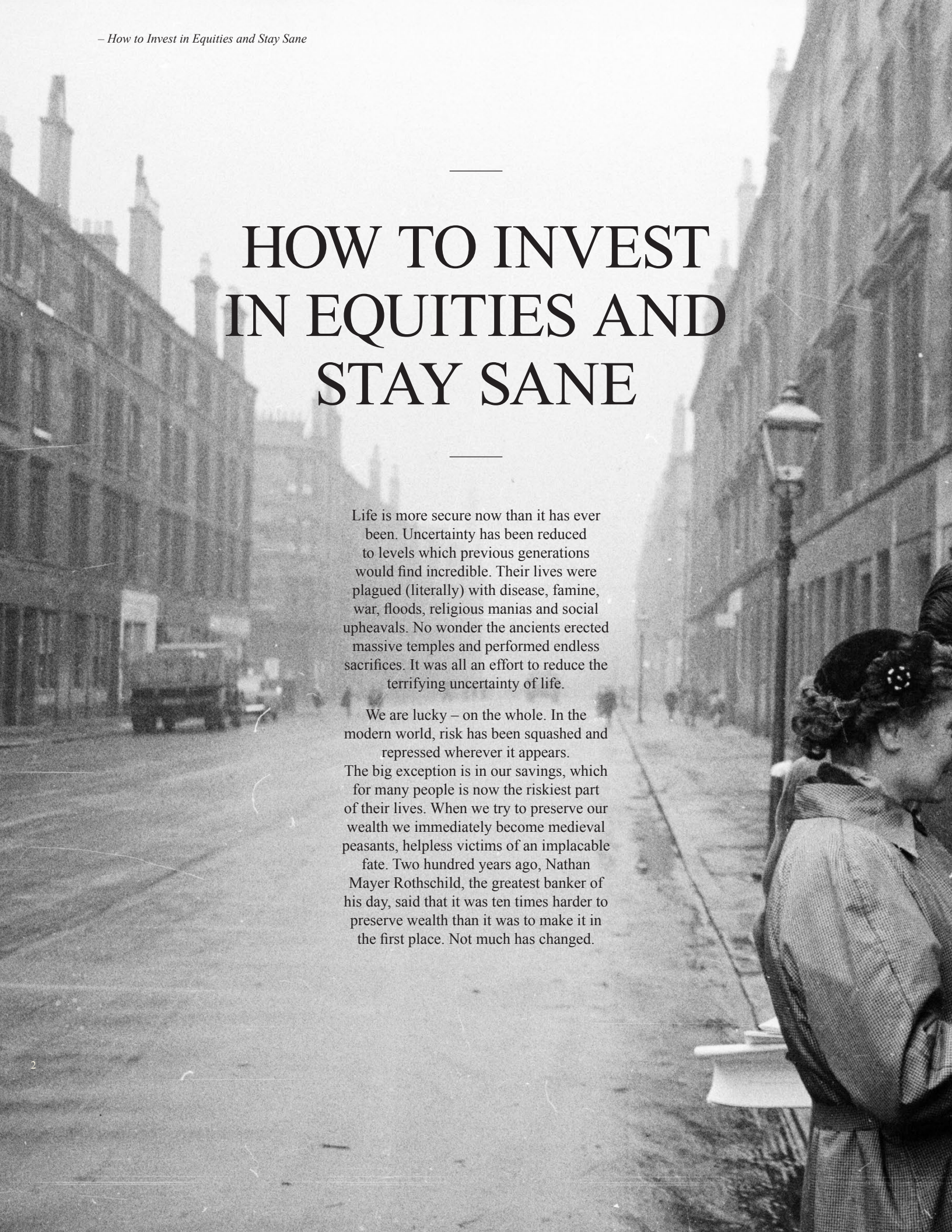


FROM THE ARCHIVE

2012

The best investment advice doesn't grow old. When former Baillie Gifford Partner Edward Hocknell wrote 'How to Invest in Equities and Stay Sane' back in 2012, 'global pandemic' was just one on a list of scenarios for business continuity managers and civil servants to plan for.

Now that this risk is upon us in the shape of the coronavirus (Covid-19), we thought Edward's paper, a reflection on the Great Financial Crisis, was well worth retrieving from the vaults. His point is not that great upheavals such as this are "irrelevant" to investors, but that however overwhelming the influence and buffetings of the news, they should not obscure the opportunities presented by the "benign adaptations which help us to survive". These "gradual and quiet" advances continue to make life better. Their progress can even be accelerated by a crisis.



HOW TO INVEST IN EQUITIES AND STAY SANE

Life is more secure now than it has ever been. Uncertainty has been reduced to levels which previous generations would find incredible. Their lives were plagued (literally) with disease, famine, war, floods, religious manias and social upheavals. No wonder the ancients erected massive temples and performed endless sacrifices. It was all an effort to reduce the terrifying uncertainty of life.

We are lucky – on the whole. In the modern world, risk has been squashed and repressed wherever it appears. The big exception is in our savings, which for many people is now the riskiest part of their lives. When we try to preserve our wealth we immediately become medieval peasants, helpless victims of an implacable fate. Two hundred years ago, Nathan Mayer Rothschild, the greatest banker of his day, said that it was ten times harder to preserve wealth than it was to make it in the first place. Not much has changed.



Glasgow Street.
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Unfortunately, we have to take risks. We have no choice, because the cost of not doing so has become immense. The entry fee to safe havens is prohibitive. Bond markets are behaving like an insurance salesman who wants to charge you more to insure your house than it would cost to rebuild. Safety guarantees loss.

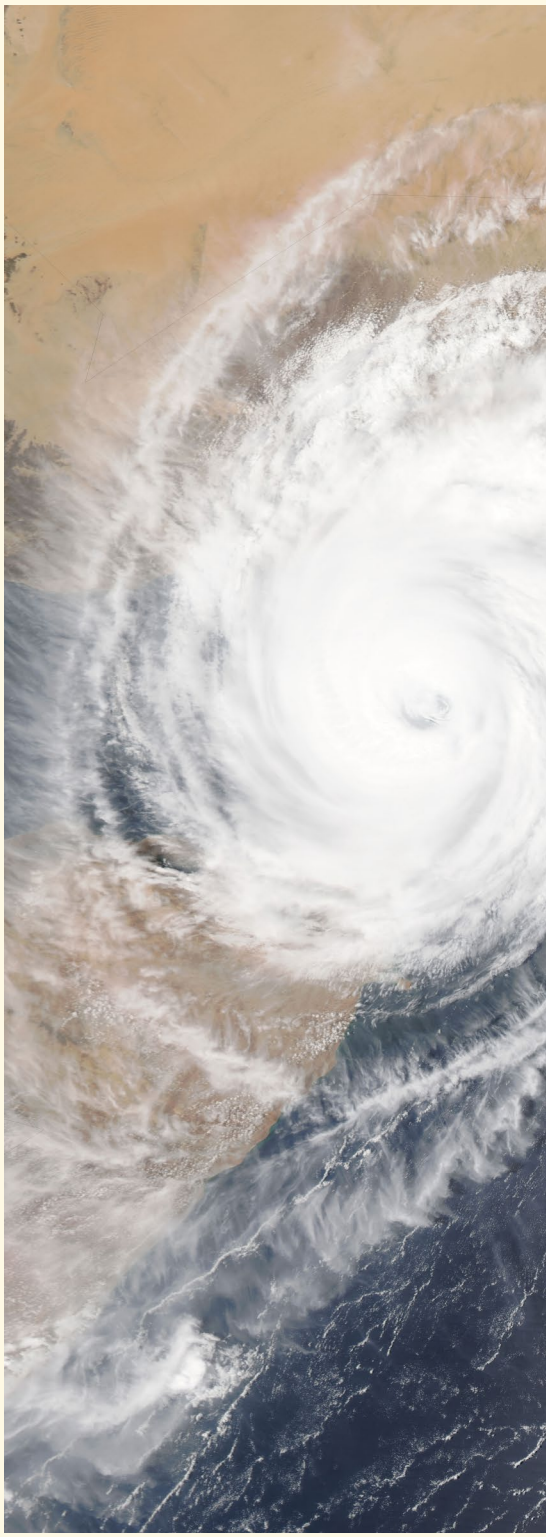
If we want a reasonable prospect of real returns, we have to invest in equities; and that means having to cope with uncertainty. As John Maynard Keynes, the great economist put it in the 1930s: 'The modern holder of quoted equities requires much more nerve, patience and fortitude than the holder of wealth in other forms'. The purpose of this piece is to instil in you, Dear Reader, that Nerve, Patience and Fortitude. The evidence is clear: it is worth it – and anyway we have no choice.

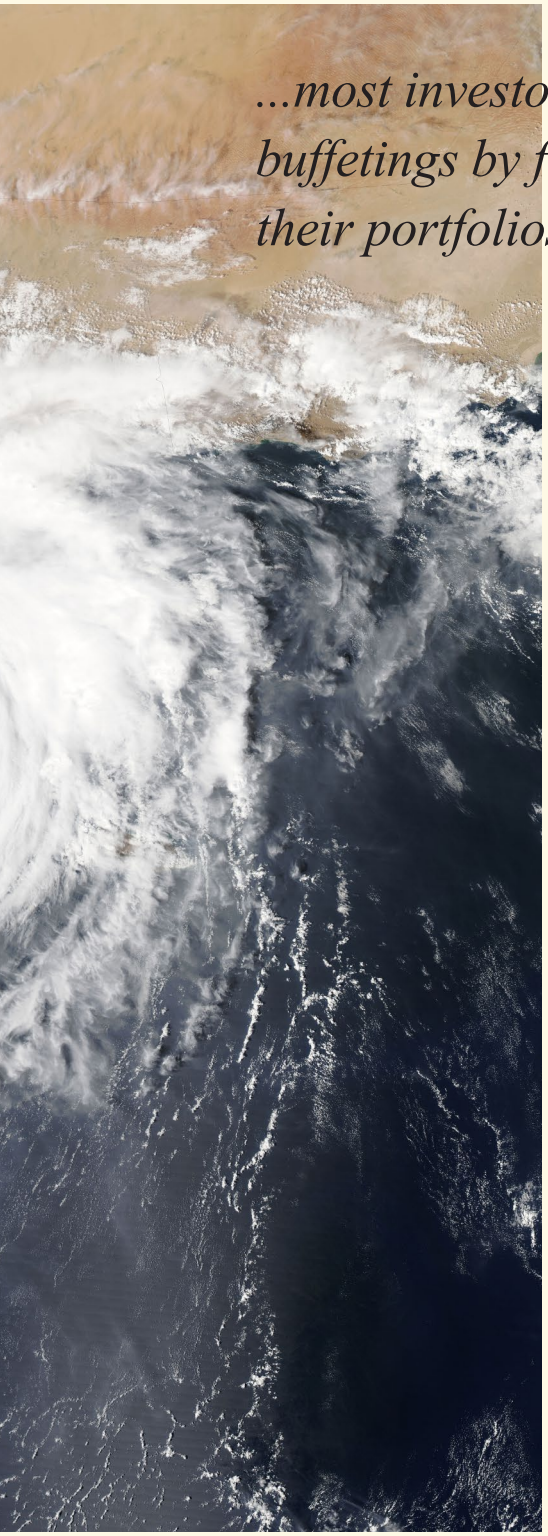
It seems to us that the greatest enemy of successful investment is 'Events'. We are all participants in an endless parade of happenings, which, being human, we continuously try to integrate into our world view. There are too many events for us to treat them critically, or test them for relevance. With our wealth at stake, we adopt a semi-conscious policy of worrying about as much as possible, and discounting as little as we can – especially if it sounds alarming. There is plenty of academic evidence for this. It is best summarised in Daniel Kahneman's excellent book 'Thinking, Fast and Slow'. He shows how we instinctively default to the most recent or striking piece of evidence, and that our urge to leap to conclusions overwhelms our better, rational selves.

Modern media make the problem much worse, of course. 'News' is crafted to grab our attention; it is not created spontaneously by the world. It is said that in 1936 a BBC announcer solemnly announced over the wireless: 'Good evening. It is six o'clock. There has been no news today'. Those days are long gone.

So, if news and events are our enemies, how do we cope with them? The first step is to regard them with the suspicion they deserve, and to be more discriminating in how we react. From the investor's point of view, most events can be put into one of three categories: a large proportion is simply irrelevant, even though it may look vital and pressing; some is misleading, sending us haring off in the wrong direction; but some is boring, underreported – and very helpful.

The rest of this paper will concentrate on giving examples of all three types of events in the hope that it will help fellow investors make some money and ignore the siren calls enticing them onto the rocks. It may also help them sleep better at night.





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THE IRRELEVANT

Most news is irrelevant and can be safely ignored. Especially pointless are the frequent predictions of things which cannot be predicted. The forecasting records of even the best economists are very poor. We know this but we still listen to them. We are like ancient Romans, who peered at chickens' livers before every battle to see who would win. We would be better off assuming that the economy does OK most of the time. Experiments show that in complicated matters mean reversion is a better tool for prediction than listening to experts.

Similarly, the huge amount of effort devoted to interpreting short-term market movements is largely pointless. The market is not a person; it does not have reasons or intentions. Its wanderings are the residual of countless opposing forces. It is not 'Trying to tell us something'. Its meanderings may well provide us with opportunities to buy or sell, but it is much easier to behave rationally if we do not believe that a fall in prices betrays some hidden horror. Similarly, a rise in prices does not mean that Santa Claus is on his way.

A great deal of political, social and global reportage is irrelevant to us too. We are trying to be good investors, not emperors. We are not responsible for the big picture; we only have to buy what we really like. Very often a story will draw us in. We become 'experts' on matters such as Greek public finance, which held no charms for us before, but which assume a disproportionate importance in our minds because we keep hearing about it. We are unwilling to write off this tediously won knowledge, so we think it must be important.

The point is not that everything is irrelevant, but that most investors are too exposed to random buffetings by forces that have no more influence on their portfolios than the gale outside their windows (this is written in Scotland). They should wrap up.

THE MISLEADING

Being somewhat contrarian, having a preference towards 'Leaning against the Wind', as Keynes put it, is a characteristic of all good investors. This can make them difficult in the home – they need understanding wives and husbands – but it helps them make money. For the contrarian, nothing is more exciting than the misleading news item.

Good news is routinely presented as bad. For example, China's decision to raise rates to combat inflation is generally received badly. But surely inflicting pain in that way is exactly the right thing to do? If a company is happy to defer profits by investing heavily today, is that really bad news? It is all a matter of having a sensible time scale. It is right to take some pain now if the eventual consequence is positive. The crisis in Europe has been a perfect example of this. Imposing Germanic fiscal discipline on a whole continent was always going to be a gradual, lengthy process. The point is that we are heading in the right direction, but almost all commentators focus on how painful each step is.

Occasionally things are worse than they look. This usually happens in times of bubbly exuberance. The most obvious examples come from the financial sector. Banks tend to write off all the bad loans they can, but this has the perverse consequence that when times are really bad and their balance sheets are weak, banks will often refrain from writing off bad loans and consequently report excessive profits. These profits are really a sign of weakness. An increase in write offs and a rise in bankruptcies are signs that the healing process has started.

The moral here is to question the conventional interpretation put on the news, especially bad news, which always gets a wider airing from the media than the good variety. If you are feeling particularly fed up about your investments, ask yourself this question: If you were a historian of the future looking back over the grand sweep of financial history, what would the really great buying opportunities of history have felt like at the time? The answer is, 'Pretty Grim.' It is always darkest before the dawn, and the successful contrarian is aware how misleading conventional opinion can be.



THE IGNORED

We are not arguing that the successful investor should ignore everything and hide away from all worldly contact: no one admires the investment skills of the Desert Fathers. The point is that the world as it is presented to us is misleading, unsettling and deeply unhelpful from an investor's point of view. We should be aware of this bias and remember that the really useful news is often ignored.

The simplest form of general ignorance takes place when facts arise which do not fit in with the conventional story. The fall in Italian long-term interest rates has been resolutely ignored by those who confidently predict a euro disaster; the facts do not fit the story. Even market prices can be a better indicator than economic statistics, if the two persistently point in different directions; and the popularity of the incumbent political leader gives you a better reading than most official measures about how well an economy is performing.

The news we are fed has a strong negative and sensationalist tilt. As the great American historian David Landes has pointed out, ultimately the only satisfaction the pessimist has is to say, 'I told you so'. The optimist is always on the lookout for the right kind of news. On the whole, things work out in the end because people adapt their behaviour. This is something that conventional analysis has a big problem with: it presents a static picture of a world in which unsustainable behaviour is always extrapolated until we run off the edge of the cliff. In the real world, people just do something else or invent something. The extrapolation fallacy is especially common in financial matters. It is obvious that America is never going to run out of dollars, any more than a man with a functioning spigot will run out of water. The naive extrapolators cannot see this.

Conventional news ignores the benign adaptations which help us survive, because they are gradual and quiet. This is especially true of our responses to price signals – perhaps because, on the whole, the news media find companies opaque and hard to understand. Investors would be well advised just to assume that big price changes will always lead to changes in supply and demand, and look for the early evidence for this in companies' behaviour. The most glaring example of this is America's imminent self sufficiency in hydrocarbons, and the discovery of huge new oil fields in Brazil, Canada, and Australia, combined with a sharp increase in the efficiency of energy use. These changes are all the consequence of the human energy released by high oil prices over several years, but the massive implications are only gradually being recognised.

Technological change is underplayed too, because its consequences are also gradual. To take one example among many: we have barely begun to understand the implications of the internet for a wide range of service industries. Can high streets and malls survive in anything like their current form? Do professional services have to be carried out in high wage countries? Do we have to travel to work? It does not take any specialised technological knowledge to play this game: the inventions which set these changes in motion were made years ago.

If all else fails and you feel the weight of events pressing too hard; if you are under pressure to make a decision you know you will regret, there is only one answer: Travel. Take a vacation somewhere without broadband. When you eventually return, you will find that the events which oppressed you have passed by and been forgotten.

LESSONS

Obsession with events is the enemy of prosperity and sanity

Bad news is often good – be somewhat contrarian

Don't take the News too seriously – it's mostly irrelevant

Supply and demand works – eventually

Technology changes the world – eventually

Stay optimistic

ABOUT THE AUTHOR

EDWARD HOCKNELL

A former partner with Baillie Gifford, Edward Hocknell joined the firm in 1984 and retired in 2012. A graduate in classics and philosophy from the University of Oxford, he worked in various investment departments including the North America desk, was on the investment policy committee, and headed the firm's investment trust business.

Since retirement Edward has sat on the boards of a number of charities focussing on education and culture, and has invested in private businesses in the food and drink sector. Away from business he "potters about" on his farm in East Lothian and pursues his hobby of painting.

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